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The length and severity of depressions depend partly on the magnitude of the "real" maladjustments, which developed during the preceding boom and partly on the aggravating monetary and credit conditions.

***Prosperity and Depression*, Gotfried Haberler**
George Allen & Unwin, London 1937

1929/30 - 1999/00

Mr. Greenspan realized his fifth mini rate hike within nine months. This time he did so with the openly declared intention to slow down the stock market. And how did investors respond? Rejoicing about his further timid and insignificant rate hike, they pushed the fashionable stocks higher again, as if nothing had changed. The Wilshire 5000 index, supposedly the best measure of total stock market capitalization for U.S. companies, rose after the rate hike by $1.2 trillion to $14.8 trillion in the seven trading days, while increasing its 2000 gain to 17%. Confidence that Mr. Greenspan lacks the courage to pierce this bubble that he has created clearly remains unshaken.

It has taken the Fed chairman a very long time to admit publicly that the huge wealth effects created by the soaring stock prices have been fostering a consumer borrowing and spending binge that is outstripping the economy's potential to produce goods and services, even though the soaring trade deficit has been telling just that for several years. It took him even longer to identify these wealth effects as a dangerous, major source of imbalance for the U.S. economy that he ought to check.

Patently, he hopes to fine-tune the American bubble economy into a soft landing. What are his chances? Mindful of the well-known postulate of the Austrian school that the severity of depressions is primarily the function of the scale of economic and financial maladjustments and imbalances that have accumulated in the preceding boom, we thought that it might be instructive to compare the present development in the United States with the conditions that led to the stock market crash of 1929 and the following depression.

There are striking parallels. In both periods, the bull market kindled the same kind of consumer borrowing and spending binge. On the other hand, there are two critical and most worrying differences. First in the scale of the credit excesses. There were similar financial excesses in the late 1920s, but they pale into insignificance when compared with those of the late 1990s. The second and most important difference lies in today's huge, chronic trade deficit and the inherent heavy dependence of the U.S. financial system and currency on incessant huge capital and credit inflows.

BULL OR BEAR?

The time Mr. Greenspan has lost in making up his mind about the need for monetary tightening has certainly made his task neither easier nor simpler. While the economy continues to boom, many stock owners have suffered heavy losses. Steep rises in the prices of a narrow group of technology shares mask weakness and even sharp declines in everything else, apparently characterizing a growing gulf between stocks of the New Economy and stocks of the Old Economy - a divergence that has become a worldwide phenomenon.

Assessing the great divide in global stock markets, please bear in mind that the two parts of the economies are of extremely different size. What ranks as Old Economy accounts for at least 95% of total economic activity. What the raging stock values of the New Economy effectively reflect is not superior profitability but rampant

money creation and rampant euphoria of investors in complete disregard of generally very poor profitability. Arthur Levitt, chairman of the Securities and Exchange Commission and America's chief market watchdog, asked the other day, "Are some of today's companies really worth 1,000 times nothing?"

In terms of the advance-decline ratio, comparing the number of falling stocks with the number of rising stocks, this "bull market" is becoming the worst bear market in history. An article in the *New York Times* recently reported a study which showed that, excluding the 66 technology and telecommunication stocks from the S&P 500 index, the remaining 434 companies are still trading at the same low levels seen during the Russian debt crisis of October 1998. With technology and telecommunication stocks included, however, the S&P 500 has risen about 40% since then. The Nasdaq has even more than tripled from its low of 1,419 since then.

With technology stocks removed from the S&P index, the price-to-earnings ratio on the median stock in the index currently stands at around 12. That is the same depressed valuation level reached on the entire index during the depression of 1990. Including technology stocks, however, the price-earnings ratio is at an extreme high of 43. It would surprise people, says the author of the study, that outside of technology, the United States' blue chip stock market may be breaking down below the lowest point of the Asian crisis.

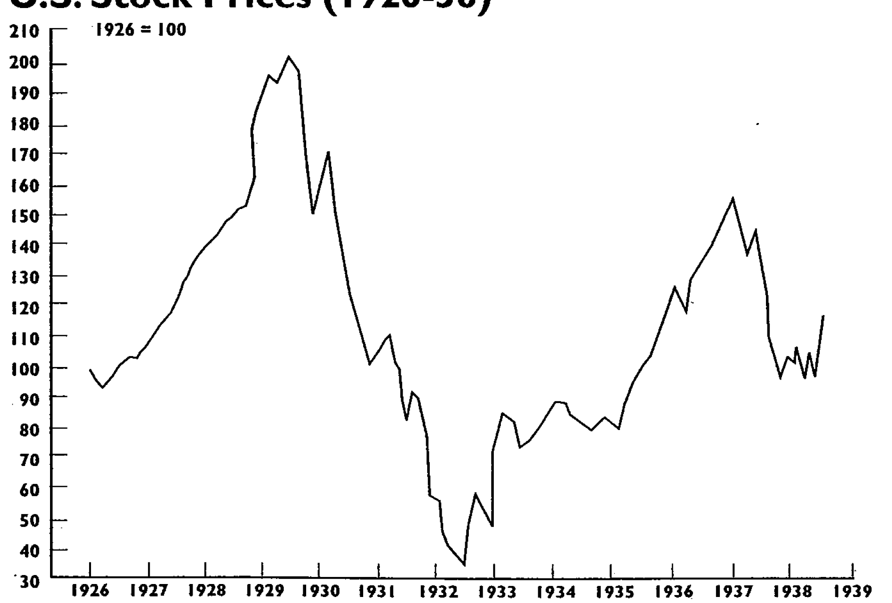
Now, what is it really? Bull or bear market? Measured by the great majority of stocks, it is, clearly, a global bear market. But market opinion, seeing no reason for a serious bear market, seems to perceive the broad decline in most stocks as a limited, temporary correction, from which the markets will recover with new strength. Meanwhile, the consumer borrowing and spending binge continues unabated.

Most importantly, the broad decline in stock prices so far has in no way dented the prevailing highly bullish faith in the U.S. economy's current and future performance.

In the public perception, the U.S. economy's only problem is too much strength. If it slows, Mr. Greenspan will simply undo his rate hikes, and the economy will take off again. Investors' expectations of stock returns over the next 12 months remain in the higher double-digits. All this tends to underscore the powerful inertia of the stock market wealth effects as an ongoing source of vigorous U.S. domestic demand growth, even though most stocks are falling.

How strong is the U.S. economy really? More to the point, how vulnerable is it to a bursting of the stock market bubble? Liking to get ideas and guidance from history, we took another close look at events in America in 1929-30 with the question in mind, what exactly happened before and after the stock market's initial crash in October-November 1929? Speaking of events, we focus on four features: *first*, monetary policy; *second*, rise and fall of the stock market; *third*, the economy; and *fourth*, general sentiment about the economy.

U.S. Stock Prices (1926-38)



New York stock prices (Standard Statistics Index) (1926 = 100), 1926-38

As to the stock market, the Dow Jones in the late 1920s went from a low of 191 in early 1928 to

a high of 300 in December. Peaking at 381 in early September 1929, the index had doubled within one year and eight months. The following decline started slowly but accelerated over time under rapidly increasing selling pressure. Most of the decline happened between Oct. 24 and Nov. 13. During these three weeks, the Dow lost 36%. But according to different stock indexes, measured losses from the highs in early September were between 45-52%. Oct. 24, 1929, Black Thursday, was to become the symbol of the Crash and the following Depression.

THE FED HAD ACTUALLY EASED

This was an unusual crash. It had happened in the absence of monetary tightening and in the face of great optimism about the economic outlook. True, the Fed New York had raised its discount rate from 5% to 6% on Aug. 9, 1929. But this was merely symbolic, as it represented a compromise. The other side of that compromise was a reduction in the buying rate for prime bankers' acceptances on the same day from 5 1/4% to 5 1/8%. By heavily increasing its purchases of such acceptances, the Fed effectively eased the money market by replenishing bank reserves. In fact, the call loan rate dropped from 9.6% on Aug. 10 to 6.2% in early October. That is, the break in the market did not come, as was usual in the past, from any monetary tightening. Financial pressure on the stock exchange was relaxing, rather than increasing, when the crash started.

In light of these facts, the sudden crash of the stock market was taken in stride as a purely financial event. There was no plausible reason in sight. In fact, stock prices promptly rallied again in December, gaining more than 20% until early April 1930. By then the "correction" was considered over. It seemed as though the crash had come and gone without any adverse impact on the economy. However, in the second half of 1930, the stock market resumed its decline with a vengeance. At its bottom, by mid-1932, it had lost 90% from its peak in early September 1929.

And what happened during those same two years, before and after the start of the crash, to the America economy? With virtually 6% growth in 1929, it had staged its highest growth rate during the whole boom. But this growth had become extremely unbalanced. Business capital investment and residential building had already peaked. Broader symptoms of slackening economic activity began to show during the summer of 1929 in industrial output, incomes, foreign trade and employment. Still, most of these early indications of malaise were not apparent before the stock market crash.

A SINGLE DRIVING FORCE

It was an unappreciated fact that the economy's ongoing boom had become dependent on a single driving force: a consumer borrowing and spending binge. See the following table. The economy's collapse, actually, started in earnest during the second half of 1930. Late in the year, industrial production was down 26%.

It appears that the bullish perception about the economy's health and strength was the last to succumb to the

REAL GDP AND SELECTED COMPONENTS, 1927-33, (BILLIONS OF DOLLARS)

	CONSUMPTION	INVESTMENT	CONSTRUCTION	GDP
1925	66.1	16.4	10.0	90.5
1926	71.5	17.1	10.7	96.4
1927	73.2	15.6	10.	97.3
1928	74.8	14.5	9.8	98.5
1929	79.0	16.2	8.7	104.4
1930	74.7	10.5	6.4	95.1
1931	72.7	6.8	4.5	89.5
1932	66.0	0.8	2.4	76.4
1933	64.6	0.3	1.9	74.2

Source: Peter Temin, Did Monetary Forces Cause the Great Depression?, MIT Harvard

dismal development in the stock market and in the economy. The sudden, rapid plunge of the economy generally took people completely by surprise. Schumpeter has described the abrupt change in sentiment in late 1930 with a sentence that became famous: "People, for the most part, stood their ground firmly. But that ground itself was about to give way." Now to the present. First the numbers.

UNITES STATES: REAL GROSS DOMESTIC PRODUCT (BILLIONS OF CHAINED DOLLARS)

	1998	1999	1998	1999			
			IV	I	II	III	IV
GDP	8,516	8,867	8,659	8,738	8,779	8,901	9,051
Personal Consumption	5,699	6,001	5,796	5,884	5,962	6,033	6,120
Fixed Investment	1,472	1,590	1,522	1,556	1,581	1,607	1,616
Structures	254	247	256	252	248	246	243
Equipment and software	871	975	908	936	961	997	1,008
Information	418	509	448	470	501	526	538
Computers	154	220	178	193	213	233	244
Software	129	149	138	142	147	152	156
Industrial Equipment	148	149	149	145	146	150	155
Transportation Equipment	175	197	186	191	192	204	200
Residential Investment	350	376	363	374	379	375	376
Inventories	71	45	71	51	18	41	71
Government spending	1,480	1,535	1,496	1,514	1,519	1,536	1,571
Net exports	- 215	-323	-232	-284	-319	- 338	- 350

Source: Department of Commerce, Survey of Current Business

Sorry for the many numbers, but the customary, conventional narrow focus on the quarterly movements in the GDP aggregate completely ignores the major dislocations that have developed in the U.S. economy with some striking parallels to 1929. On the surface, considering the annualized growth rates of 5.7% in the third quarter and of 6.9% in the fourth quarter of last year, it appears, indeed, that the economy is still firing on all cylinders. Yet a closer look reveals something else. Appraising the most recent GDP numbers, we sort out two items that have chiefly accounted for the growth acceleration: inventories and government spending.

Together, the two contributed 1.90 percentage points in the third quarter and even 2.94 percentage points in the fourth quarter to overall real GDP growth. In their absence, GDP growth would have been 3.9% (instead of 5.7%) and 3.94% (instead of 6.9%). The latter in particular was heavily distorted on the upside by jumps in government spending on farm subsidies and Kosovo.

THE FIRST CRACKS

The other feature striking the eye on a closer look at this table is the weakness in fixed capital investment. The weakest component, actually shrinking, is the spending on structures; in other words, business spending on commercial and industrial buildings. Their longer-term weakness, by the way, perfectly conforms with our opinion that the obsession with short-term range share price maximization essentially tends to cap long-term investment. Residential building has been stagnating since the second quarter of 1999, though on a high level.

Any strength in fixed capital investment comes from one component, "Information processing equipment and software," accounting last year for 90% of the total increase in private fixed investment last year. Industrial equipment - that is, investment in production machinery - has been stagnant for more than two years, except for a little bounce in the second half of last year.

Please note, though, that the greater part of this investment boom in high tech, as we have repeatedly commented, does not reflect effectively higher spending in dollars but the collapsing prices of computer power, as measured by the ominous "hedonic" price deflator. Business spending on computers and peripheral

equipment rose last year in actual dollars by a mere $9.2 billion to $97.7 billion. But the price deflator elevated this minimal amount into a boom-like increase in "chained" dollars by $66.3 billion.

Sluggishness in investment spending is a striking and important parallel to 1929. An unsustainable consumer borrowing and spending binge is the other one. In 1928-29, consumer spending accounted for 82% of real GDP growth. In 1999, that ratio was 86%. If it were not for the big statistical boost to business investment by the computer deflator, the share of consumer spending in real GDP growth this time would be nearer to 95%.

THE WORST IN HISTORY

The economic contraction that started in 1929 was the worst in history. Given the scale and importance of this event, it is remarkable how little is generally known about both its course and its causes. Most probably, this largely has to do with the predominant conviction that the central banks and governments of today possess the superior wisdom and the better instruments to keep everything under control. Why bother about foolishness in history?

In principle, there are two diametrically opposite explanations of the unusual severity of the Great Depression of the 1930s. One strongly associated with the leading economists of the Austrian School (Mises, Hayek) regards the Depression as the unavoidable, disastrous end of the unsustainable, structural maladjustments which the monetary and financial excesses had inflicted between 1927-29 on the economy and the financial system. In this view, the severity of any depression is largely predetermined by the magnitude of the economic and financial maladjustments that have accumulated during the preceding boom.

This view about the ultimate cause of the Great Depression predominated among economists around the world until the early 1960s. But one book, appearing in 1963, radically changed that view, at least among American economists. It was Friedman's and Schwartz's classic, *Monetary History of the United States.* This book categorically postulated that there had been neither inflation nor any money or credit excesses in the 1920s that could have caused the economy's collapse between 1929 and 1933. From this followed the conclusion that the Great Depression essentially had its crucial cause in policy faults that were made during these years.

To quote a decisive passage from the book, ***"The monetary collapse from 1929 to 1933 was not an inevitable consequence of what had gone before. It was the result of the policies followed during those years. As already noted, alternative policies that could have halted the monetary debacle were available throughout those years. Though the Reserve System proclaimed that it was following an easy-money policy, in fact it followed an exceedingly tight policy."***

For American economists, the views expressed in this book on the role of monetary policy in precipitating the depression have become standard history and the standard explanation of the Great Depression. One important, inherent conclusion of this monetarist approach for the future was the comforting message that sufficient monetary easing is enough to prevent a serious recession after a boom. This is, for sure, one assumption of central importance behind the currently prevailing bullishness about the U.S. economy.

Considering the still-booming economy and the reigning optimism about the economic outlook, the Federal Reserve responded in October-November 1929 with admirable promptness to the crash. On Nov. 1, when the selling panic was barely one week old, the Fed slashed the discount rate to 5% and a fortnight later to 4.5%. On Oct. 25, one day after Black Thursday, it had instantly reduced its buying rate on acceptances from 5 3/8% to 5%. This was followed by a rapid sequence of further cuts to 4% on Nov. 21. Yet the economy - see table on page 3 - collapsed across the board with unprecedented and unbelievable rapidity like a house of cards.

THE ROLE OF THE CRASH

We have always favored the explanation of the Great Depression tendered by Austrian theory. Of the various considerations speaking in its favor, one appears to us compelling, and that is the extraordinary speed and breadth of the economy's plunge. Consider that real GDP fell in 1930 abruptly by 9%. Such a virtual collapse can only happen to an economy that is badly out of balance and therefore highly vulnerable. The big contraction in the money supply by 42% to which Milton Friedman attributed the Depression only started in late 1930, not in precedence but in coincidence with the economic collapse. The one big event that had preceded the economic collapse was the start of the stock market crash.

Yet the role of the crash in precipitating the economic and financial disaster is highly controversial among American economists. It is estimated that the stock market crash involved a wealth destruction of about $85 billion in total. Capital losses in the first wave of the crash in late October and early November 1929 amounted to about $25 billion. This compares with a decline in the stock of broad money between late 1930 and end-1933 by $13 billion. But for Milton Friedman, the money supply's shrinkage was the one and only decisive mechanism that drove the economy into the protracted, deep depression. And what's more, this monetary shrinkage in his view had no other cause than coincident, bad policies of the Fed.

We would never dispute the decisive importance of the following, drastic monetary contraction during those years, but it grossly defies any logic to discard the prior, rapid and huge wealth destruction through the stock market as almost a non-event. In the logic of the Austrian theory, the booming stock market had operated to prolong the boom by unduly boosting wealth-related consumer spending. As soon as stock prices collapsed, this artificial element in consumer spending evaporated with a prompt and, heavily negative effect on economic growth in 1930.

In reality, personal wealth is not the only victim of such a crash. Overall liquidity is the other victim. It is a gross mistake to measure liquidity only by changes in the money stock. Far more important is the liquidity of assets, financial assets above all, in the markets. In times of loose money, low interest rates and booming markets, corporations, financial institutions and consumers tend to reduce their cash balances in favor of financial assets, regarding them under given bullish market conditions as highly liquid assets.

As long as the stock market kept booming, the vast stock holdings represented, indeed, highly liquid assets for their owners. But the plunging stock prices transformed these huge stock holdings abruptly into illiquid assets which could only be liquidated at a heavy loss. Considering the amount involved in this wealth and liquidity destruction, we don't have the slightest doubt that the stock market crash was the most important, immediate cause of the ensuing depression. The pattern of the depression might well have been radically different from what happened had it not been preceded by the stock market catastrophe. But this implies, indeed, that the Great Depression primarily originated in the excesses of the preceding boom.

DISPUTED CAUSE

With these questions and aspects in mind, we have drawn a comparison between events and excesses in the late 1920s and in the late 1990s. How do the monetary and credit excesses in the two periods compare in kind and scale?

Before we come to the tremendous differences, first an important common feature: In both periods, credit creation took place overwhelmingly outside the banking system - that is, through the securities markets and the money markets. Also common to both periods is the complete absence of Federal government borrowing. All the borrowing and lending that took place was on account of the private sector, businesses and consumers.

Next, we have to point out that credit is the most neglected aggregate in American history books about the 1920s. In their voluminous Monetary History of the United States, Friedman-Schwartz don't bring one single figure about

credit growth, but instead pages and pages of detailed figures about money growth from month to month. They don't even mention the ill-reputed brokers' loans for stock speculation, totaling $8.5 billion at their peak in September 1929. Consumer borrowing in the form of installment loans played a great role in fueling the consumer spending boom in the 1920's, but statistics about their extent and source of finance are non-existent.

As explained in past letters, one critical measure of credit "excess" is growth of credit relative to the simultaneous nominal GDP growth as the statistical denominator of growth in economic activity. During the four years from end-1925 to end-1929, U.S. GDP grew by $13.9 billion, or 15.3%, from $90.5 billion to $104.4 billion.

Over this same period of four years, corporations issued securities for $27.4 billion, of which more than $10 billion in equity. Total bank loans increased by about $8 billion during these years, mostly for mortgage lending. Further considerable lending took place through institutions outside of the banking system, chiefly savings banks and building and loan associations. However, no statistics are available. The habit of America economists to focus exclusively on the money supply and to ignore credit has a long tradition.

Yet despite the lack of comprehensive statistics, the available evidence leaves no doubt that there was rampant credit creation. This recognition is very important because, in striking contrast, the money supply grew only modestly. Between 1925-1929, broad money grew by no more than 10%, from $50 billion to $55.5 billion. Demand deposits at banks in late 1929, at $22 billion were no higher than in late 1925. But this weakness in money growth, as already mentioned, had its cause by no means in lacking credit expansion but in the fact that credit creation occurred overwhelmingly through the securities and money markets, essentially involving no money creation. Stock prices, at any rate, more than tripled, and the total value of all shares listed on the New York Stock Exchange soared from $27 billion in 1925 to $89 billion at their peak in early September 1929.

THE BANKS FLOOD THE MARKETS

This brings us to one of the most important and most striking differences between the boom of the 1920s and that of the 1990s. It concerns the financial strategy of corporations. At the time, corporations took full advantage of the abundant availability of cheap capital and issued bonds and stocks vastly in excess of their investment needs. In 1929, almost 70% of total corporate issues in securities were in stocks. To quote Schumpeter on this point: American corporations "eventually entered the Great Depression with a financial outfit which was nothing short of luxurious." Many of them could finance their investments for years to come with the funds they had raised during the speculative mania of 1928-29.

What did the corporations do with their surplus cash? Well, they did put it straight back into the stock market, but through a different channel. Instead of buying stocks for their own account, they lent these funds in large part as call loans at 10% and more to brokers, who financed soaring margin loans for the stock speculation of their clients. In the last 12 months before the crash, brokers' loans increased by 50%.

However, this over-liquidity of corporations amassed from the heavy issuance of securities had further monetary implications. For the banks it entailed the loss of their traditional chief borrowers. As the lending to corporations came to a complete stop, the banks had to look for alternative sources of revenue. After all, they embarked aggressively on two new outlets: *investments* in corporate bonds - and stocks through affiliates - and security loans, that is, loans to buyers of stocks and bonds against bonds and stock collateral. In the last analysis, it was the banking system that fueled the boom in the bond and the stock market, partly though purchases for their own account, partly through loans to other buyers of stocks and bonds.

To cite from a contemporary report by the League of Nations about this development: ***"The credit expansion after 1927 in the United States went largely to the financing of speculation. According to available***

statistics, no less than 86% of the total increase in bank credit was used for that purpose. Thus was laid the foundation for the stock-exchange boom which followed."

EXCESSES COMPARED

Now to the present, with the postulate of the Austrian theory in mind that every economic and financial bust is in large part a function of the scale of excesses in the preceding boom. The gauges to look at are self-evident: *first*, stock valuations; *second*, money and credit expansion; and *third*, economic fundamentals.

As to valuations, the collapse of the stock market started in early September 1929 with the price-to-earnings ratio at a level of 13.5, after a high point of 16.2 in January. In comparison with a traditional 10 to one ratio, these valuation levels unusually high looked at the time. Measured against the ratios of today - around 29 for the S&P 500 index, around 35 for the S&P Industrial Index and more than 200 times earnings for the Nasdaq - those of the late 1920s appear almost insignificant. To mention another measure: Before the 1929 crash, the total capitalization of listed stocks tallied with about 100% of GDP. This time, it has been almost 200%. In short, present stock valuations vastly exceed those in the late 1920s.

Next: underlying money and credit expansion. How do they compare for the two periods? As already mentioned, money in its broadest measure increased during the four years between end-1925 and end-1929 by 10% while narrow money (M1) stagnated. For comparison: During the four years from end-1995 to end-1999, broad money (M3) has grown by a stunning 41%, or more than twice the simultaneous GDP growth.

If money growth has been record-breaking, it is wildly outdone by credit growth, which, like in the 1920s, is overwhelmingly taking place outside of the banking system. Mr. Greenspan has presided over a credit explosion that simply defies reason and comprehension. Looking exclusively at the inflation rate, he readily sanctioned a free-for-all in credit creation. In 1995, total financial and non-financial credit had expanded by a little more than $1 trillion. After a rise to $1.4 trillion in 1997, credit flows abruptly swelled to more than $2.1 trillion in 1998 and further to $2.25 trillion in 1999. In comparison to GDP growth of $459 billion in 1998 and of $500 in 1999, credit creation has been truly running amuck.

THE GREAT DIFFERENCE: CORPORATE FINANCE

Yet there is still another critical and dramatic difference between the two periods to be noted. It concerns corporate finance. In the late 1920s, as already expounded, American corporations frantically bolstered their liquidity by issuing equity vastly in excess of their financial needs for investment spending. In the past years, American corporations have pursued the diametrically opposite policy. They frantically depleted their liquidity and embarked on an unprecedented borrowing binge to finance acquisitions and repurchases of their own stocks. For the S&P 500 companies, for example, the debt-to-equity ratio has shot up over the last 10 yearsfrom 84 to 116.

For sure, a fascinating difference. But why? Of the two patterns, the one of the 1920s hardly needs explanation. Bolstering liquidity in times when booming markets offer cheap capital for the long haul, is just traditional corporate financial strategy. Yet the massive issuance of new stock may well have played an important role in breaking the boom in 1929.

The puzzling part is what has been happening in the late 1990s. Even though high tech companies are heavily tapping the stock market with IPOs, the corporate sector, as a whole is the big net buyer in the stock market on account of soaring acquisitions and stock buybacks.

Purchasing shares with record-low dividend yields around 1% at sky-high prices above book value with borrowed money that costs at least 6-7% is clearly at odds not only with corporate tradition but also with a

reasonable profit calculation. In short, it's a folly. But the widespread adherence to this folly suggests a general compelling reason which is, indeed, easy to identify: unprecedented obsession with short range maximization of shareholder value.

Plainly, under this imperative corporate governance philosophy has radically changed in the United States. But for the better or for the worse? The bullish consensus view claims dramatic improvements in corporate efficiency and takes it for granted that this change - in conjunction with the new technology - is essentially at the heart of the U.S. economy's astonishing, recent growth performance.

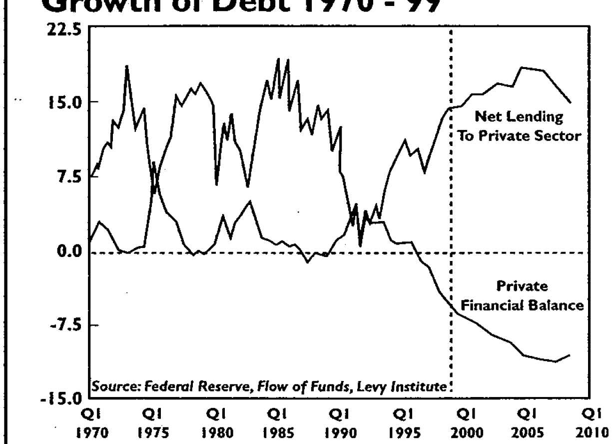
Yes, corporate strategy and policy in the new market climate have in many ways radically changed. In their frenzied endeavor to increase shareholder value, corporate managers resorted mainly to two devices. Reckless financial leveraging and a cost-cutting mania. Financial leveraging implies to run down cash balances and to substitute debt for equity. The emphasis on cost-cutting as a means to raise profits and share prices has implicitly fostered mergers and acquisitions in preference to new capital investment. Under this new American capitalism, buying existing capacity has precedence over creating new capacity, while paper wealth creation through booming stock prices has precedence over wealth creation through real capital investment. And the use and allocation of real resources has led to a major shift in the composition of GDP towards private consumption, rising to its largest ever share in current GDP growth.

NEW PARADIGM OR BUBBLE?

What are we really looking at in the United States? A supply-driven new paradigm economy or history's greatest financial bubble masking the economy's bad fundamentals? Comparing present economic and financial conditions with those in the late 1920s is a shocking exercise. Consider that the U.S. economy in the 1920s had **zero** inflation for years, owing to high productivity growth. It had a persistent surplus in savings and in foreign trade, and it had strong profit growth in 1928-29. Not to forget moreover the opulent cushions of liquidity that the corporations had accumulated through stock issuance while the stock market was booming. Is this unprecedented prosperity or unprecedented illusion?

And how do these economic and financial fundamentals look today? In short, they make miserable reading in every single respect. All of them are negative. What's more, negative in the extreme. Despite substantial statistical manipulations (as described last month), the U.S. inflation rate is above 3%, the highest rate among industrial countries. America has the lowest domestic savings of all time and the biggest trade deficit of all time. On top of being a low-saving, low investment economy, America is now a capital-consuming country, reflected in the fact that the current rise in foreign indebtedness exceeds net domestic investment.

Private Financial Balance & Growth of Debt 1970 - 99



Ominously, corporate profits, as measured by the official income statistics, have been virtually flat for more than two years, even though the economy has been booming at record growth rates. The stampede of both corporations and private households out of liquidity and into debt during recent years is without precedent. The following chart gives an idea of the drastic deterioration of liquidity in the private sector during recent years.

First question: Is the incredible stock market boom a reflection of real value created in the economy, or is it a purely credit-driven paper bubble? Second question: What

are the chances that the Fed will be able to prevent a devastating crash of the stock market and engineer a soft landing of the economy?

Our preliminary answer: The accumulated financial excesses and economic imbalances are far too big for such a happy end to be possible. Their huge scale essentially implies a disastrous bust. Under the influence of the monetarists, most American economists hold the view that it lies in the hands of a central bank to prevent any such bust from happening by simply "printing money." But by focusing narrowly on the banking system and the money supply, they overlook two snags. One is the monstrous scale of credit creation to which the U.S. economy and its financial system have become addicted to in the last years, and other one is the channel of this credit creation. Just as in the 1920s, it is overwhelmingly taking place outside of the banking system, through the financial markets Essentially, any disruption in these financial flows has the very same adverse effect on economic activity as a disruption in bank lending, irrespective of what is happening to the money supply. The usual pattern and early indicators of such disruptions are declining asset prices and widening interest rate spreads between papers of different quality. Considering the vast sums involved in the markets, it should be clear that the biggest danger to the U.S. economy looms in the financial markets, including the currency market and the derivatives markets.

DOLLAR CRISIS POSTPONED

Since its inception on Jan. 1, 1999, the euro has lost about 17% in value. We have to admit to be among those who grossly failed to see this coming currency disaster. But as a matter of fact, our main error was in the evaluation of the dollar. We have always been vigorously opposed to the introduction of the euro, for one main reason: all international bodies foster collective irresponsibility. In this respect, we must say, Mr. Duisenburg and his colleagues have easily met our worst expectations. Ironically, German politicians and Bundesbank members have repeatedly distinguished themselves as outspoken monetary and currency softies.

The European Central Bank has lost credibility for a number of reasons. Not all of them make sense. First of all, we strongly disagree with the prevailing view that central bankers ought to prepare markets ahead of interest rate moves. Mr. Greenspan is the first central banker to do this, and all of sudden it is hailed as the token of good and credible monetary policy. All too plainly, however, Mr. Greenspan has done so with the overt intent to soften the bite of his already-flimsy rate hikes. If he wanted to weaken any impact of his measures, he could not have done better. For good reasons, he enjoys, after all, unmitigated credibility, but credibility in what respect? To be sure, in his determination and ability to fend off any serious harm to the bubble and in his readiness to be fast on the trigger if it looks like a recession is brewing. In the past, no central banker would have been proud of this reputation. Monetary policy works primarily through convincing people of impending, genuine restraint. Mr. Greenspan has continuously convinced them of his opposite intentions.

Euroland is running a current account surplus of about $50 billion, down against $60 billion in the year. Average consumer-price inflation has risen to 2% in February, after 0.8% at the euro's start in early 1999. Core inflation, excluding volatile prices, is at an annualized rate of 1.2%. But the European Central Bank regards the overall rate of 2% as the highest acceptable limit for inflation. Mainly responsible for both the deterioration in the trade surplus and the inflation rate is clearly the big boost to import prices from the euro's sharp fall. Germany, for example, reports an increase in import prices recently by 9.2% year-over-year. In the same vein, the decline in the current-account surplus of Euroland is more than explained by the inherent drastic deterioration in the terms of trade.

America, by comparison, in 1999 had a current-account deficit of $339 billion, after $220 billion in 1998. In the fourth quarter of 1999, that deficit was running at an annual rate of $400 billion. The consumer-price

index was up 3.2% in February against a year ago. This is the highest inflation rate among the industrial countries. Considering the many downward revisions to "improve" the price statistics, this is a pretty high inflation rate in the present global environment. Despite the spurt in the oil price, prices of imported goods are 10% below their level in 1996.

The strong dollar tells us that the huge and soaring trade deficit is being overfinanced. That is, U.S. capital inflows exceed the gap in the current account. Conversely, capital outflows from Europe persistently exceed the region's trade surplus. It is the generally accepted bullish dollar story that the strong capital outflows from Europe reflect the immense appetite of European companies for mergers and acquisitions in the booming new paradigm U.S. economy. In diametric contrast, the economy of Euroland is perceived as the backward region in the world, where governments and corporations are too reluctant to buy the superior American corporate governance model.

As so often happens, perception and reality dramatically diverge. Looking for the reality behind dollar strength and euro weakness, we register one factor as the most important one: heavy borrowing of American corporations abroad, above all in the euro. Lower interest rates, a market with great breadth and a persistently falling currency made the euro a most attractive currency for U.S. corporations to borrow in. While figures for 1999 as a whole are not yet available, total corporate borrowing abroad has been running at an annual rate of well over $300 billion, after $218 billion in the year before.

Second in importance behind the weakness of the euro was a massive shift in American foreign stock holdings out of Europe, including England, and into Asia, chiefly Japan. According to Ned Davis Research, American investors unloaded European shares to the amount of $61 billion last year and bought Asian shares for $45 billion. This was clearly a main factor behind the extraordinary weakness of the euro also against the yen.

As to the story that the strong dollar primarily accrues from a stampede of Corporate Europe into the Promised Land of the new paradigm American economy, it is just another fairy tale. Excluding some spectacular stock-financed acquisitions, net purchases of U.S. stocks on the part of Europeans investors and corporations have been increasing rather modestly. The biggest buyers, by the way, are British corporations.

It is an intriguing question, why American investors switched last year so massively out of European shares and into Japanese shares. After all, they pocketed substantial gains, though more on the rising yen than on rising share prices. European stocks did much better, but the currency so much worse. But without the big exodus of American investors, Europe's stock markets and the currency would, of course, have fared a lot better. Japanese investors were heavy sellers of domestic shares; European investors were heavy buyers of their domestic shares.

Comparing the performance of Europe and Japan's economy during recent years, this investment stance of American investors is difficult to understand. During the three years 1997-99, the Japanese economy had on balance zero growth. Modest increases in GDP during 1997 and 1999 were offset by a sharp decrease in 1998. As opposed, real GDP growth in the euro area averaged 2.2%, 2.8% and 2.1% in these three years, and is expected to head toward 3% in 2000. Sure, this looks poor in comparison with the American record, but measured against Japan it appears almost like Goldilocks. Europe's profit performance, in particular, is far superior to that in Japan.

During the past year, American economists have persistently predicted the impending recovery in Japan, Which probably explains the rush of American investors into Japanese shares. It was widely argued that many Japanese corporations - in contrast to European corporations - have seen the light of American shareholder value governance. Based on the monthly reports of the Bank of Japan, we have just as persistently maintained the

opposite view that there was nothing in sight to hope for a self-sustaining recovery in Japan. While profits, exports and industrial production are meanwhile showing signs of improvement, domestic demand remains broadly lifeless. One sentence in the latest report of the Bank of Japan particularly intrigued us: "The year-to-year growth in broad money has slowed somewhat, reflecting the stagnant credit demand."

CONCLUSIONS:

Quote

There is definitely no new paradigm economy in the United States. What we are witnessing are indescribable financial excesses, an unprecedented increase in debt, the monstrous use of leverage upon leverage, a collapse in private savings and an exploding current-account deficit.

This is history's greatest financial bubble.

What perpetuated the runaway boom in the stock market are two fixes: unprecedented pumping of the money and credit supply and unprecedented pumping of hype about Internet, computers and telecommunication. While the advancements in the new high tech are extraordinary, their actual economic value is limited.

The massive divergence between stock prices and breadth in the U.S. stock market is definitely indicative of a market that is losing vitality and becoming increasingly vulnerable to any negative event in the economy or the financial system. Mr. Greenspan now wants slower economic growth. For sure, he will get it. But it will devastate business profits.

Considering moreover the immensity of existing leverage in the economy and the financial system, there is nil chance for a soft lending. Misguided faith in the new paradigm economy and Mr. Greenspan's monetary ingenuity is still holding things together. Yet the time to face the many imbalances in the economy and the financial system is close at hand.

The risk that we regard as paramount is the one that is most neglected in public discussion: a plunging dollar and an associated rise in imported inflation. Confidence in a strong dollar has played a crucial role in fostering the conditions for the stock market bubble and the bubble economy. A savage bear market in stocks implies a savage bear market in the dollar.

America's confrontation with reality will begin when the economy shows more distinct signs of slowing and disillusion about the economy and Mr. Greenspan sets in. We wonder whether this may happen in the second quarter or in the second half of this year.

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